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CITY OF MOUNTAIN VIEW
MEMORANDUM

DATE: January 31, 2003

TO: City Council

FROM: Kevin C. Duggan, City Manager
Nadine P. Levin, Assistant City Manager
Robert F. Locke, Finance and Administrative Services Director
Patty J. Kong, Assistant Finance and Administrative Services Director

SUBJECT: FEBRUARY 4, 2003 STUDY SESSION—BUDGET UPDATE/REVIEW

The purpose of this study session is to provide the Council information regarding:

- General Overview of City Finances (all funds).
- General Fund Major Revenue Sources.
- General Fund Expenditures.
- General Fund Revenue/Expenditure "Balance."
- Potential State Budget Impacts.
- Guiding Principles.
- Potential Budget-Balancing Strategies.
- Budget Process/Schedule.

Attached to this report are the slides to be presented at the study session.

The basic services of the City are funded from the General Operating Fund. The General Operating Fund faces the greatest financial challenges and is the main focus of this study session. General Operating Fund revenues reached a peak of $82.7 million in Fiscal Year 2000-01. During Fiscal Year 2001-02, the rapid and sharp decline in the economy affected City revenues, with revenues dropping $10.1 million, or 12.2 percent, to $72.6 million. As City revenues have historically been susceptible to volatility, an Economic Stabilization Contingency (ESC) of $5.6 million was adopted for last fiscal year. The ESC is a positive balance of budgeted revenues over expenditures that allows revenue shortfalls to be absorbed without reducing the operating budget and still maintain a balanced budget. The ESC has been very effective in avoiding midyear budget reductions when revenues do not meet budget expectations. The ESC also played a critical role in helping adjust to the major decline in revenues noted above. For the current fiscal year, revenues were adopted at $72.7 million and the ESC at $2.1 million. Local economic conditions have resulted in current revenue estimates falling short of budget and it is estimated the ESC, once again, will be completely absorbed by revenue declines that have occurred since the adoption of this fiscal year's budget.

General Overview of City Finances (all funds)

The City maintains a variety of different funds with different revenue sources and restrictions on expenditures. Generally, resources from one fund cannot be commingled or used for the purposes of another fund. For example, the Water Fund generates revenues from ratepayers and the expenditure of these revenues is restricted to the provision of this service.

The City has seven major funds; they are the General Operating Fund, Revitalization Authority, Shoreline Golf Links, Shoreline Regional Park Community, Water, Wastewater and Solid Waste Funds. The periodic financial reports submitted to Council generally focus on these funds.

The City's General Operating Fund is the fund that supports the majority of the operations of the City (public safety, community development, public works, administration, etc.). This is the fund that is currently facing the most challenges and will be the focus of this study session.

General Fund Major Revenue Sources

During this study session, staff will be discussing the major revenue sources of the General Fund—property tax, sales tax, other taxes (including hotel and utility users taxes), interest and property leases, intergovernmental, miscellaneous revenues and loan repayments. The General Fund's single largest revenue source for many years has been sales tax. Sales tax has been a very volatile revenue source, reaching a peak in

Fiscal Year 2000-01 of $24.1 million and currently estimated at $14.3 million for this fiscal year. This is a decline of $9.8 million, or 40.7 percent, in this revenue alone.

Other major revenue sources severely impacted by the recession are the Hotel (Transient Occupancy) Tax and development fees. As noted earlier, in the mid-1990s, the City created the Economic Stabilization Contingency to assist in the management of volatile revenue sources. This contingency is a positive balance of budgeted revenues over expenditures that allows revenue shortfalls to be absorbed without reducing the operating budget. By not budgeting and spending all revenues on operations, the City has had greater budget stability and year-end balances available for capital projects and other purposes. The current fiscal year budget included an Economic Stabilization Contingency of $2.1 million, which has been used to absorb revenue declines that have occurred since the adoption of this year's budget.

<u>General Fund Expenditures</u>

The City provides a diverse and wide set of services internally and to the public. It is staff's intent to provide the Council with an overview of each department's functions, expenditures, revenues and staffing.

There are certain cost increases that cannot be avoided, or may be difficult to avoid, in next fiscal year's budget. Contractual agreements with represented groups include COLAs (cost-of-living adjustments) and other compensation increases. Costs for medical insurance and other benefits are also projected to increase. Additionally, there may be other unavoidable, noncompensation-related increases that require funding. With our best-case scenario showing no revenue growth, it will be necessary to reduce costs and services in order to balance next year's budget. Since revenues are likely to decline, even more significant reductions will be required.

<u>General Fund Revenue/Expenditure "Balance"</u>

The adopted budget for the current fiscal year was balanced including an Economic Stabilization Contingency of $2.1 million (revenues exceeding expenditures by $2.1 million). However, at this time, midyear estimates indicate actual revenues will fall below budget by approximately $2.3 million, thereby completely absorbing the Economic Stabilization Contingency. Generally, there are savings from underspending the annual budget. With the elimination and unfunding of 14.6 FTE positions and decreases in departments' operating budgets of $2.4 million, departments have tighter budgets with less savings than normal. Currently, it is estimated there will be savings of approximately $1.0 million. The net result is an estimated balance of revenues over expenditures of approximately $800,000.

Given an operating budget of $70.6 million and unstable revenues, 1.1 percent of the operating budget is too close a margin to ensure the current-year budget will remain balanced. As such, staff has implemented additional expenditure control measures to manage the budget for the current fiscal year. These measures include a hiring freeze on most permanent and hourly employees, placing restrictions on travel, reviewing and deferring all nonessential purchases and working with departments to meet a budget savings target by fiscal year end.

It is expected, at best, that there will be no revenue growth in Fiscal Year 2003-04 and next year's General Fund revenues will not be sufficient to finance normal cost increases, preliminarily estimated at $4.5 million, necessary to maintain the existing level of City operations (e.g., increases related to salary and benefits and operating costs). The combination of cost increases and likely State budget impacts to revenues leave the General Operating Fund with an estimated budget shortfall that could range as high as $8.0 million to $9.0 million (depending on the degree of the State budget impact).

It is anticipated that significant expenditure reductions, resulting in service-level adjustments, will be necessary next fiscal year. The City has taken actions to curb expenditures in the current fiscal year and City departments have prepared budget reduction proposals for the upcoming fiscal year. Specific proposals to balance the City's budget will be reviewed with the City Council during the Fiscal Year 2003-04 budget process.

Potential State Budget Impacts

The State is experiencing unprecedented financial difficulties with estimates of the deficit ranging as high as $35.0 billion. The Governor has issued a midyear budget reduction proposal to balance the State's current-year budget and further reductions in the proposed State budget for next fiscal year. The proposals impacting the City's General Fund revenues this fiscal year and in Fiscal Year 2003-04 are listed below:

Fiscal Year 2002-03

Reduction of the State backfill of the Vehicle License Fee	$1,350,000
Suspension of State-mandated cost reimbursements	150,000
Reduction of Public Library funds	50,000*
Total Revenue Loss for Fiscal Year 2002-03	$1,550,000

*Already included in Adopted Budget

Fiscal Year 2003-04

Elimination of the State backfill of the Vehicle License Fee	$2,850,000
Suspension of State-mandated cost reimbursements	150,000
Elimination of Police Booking Fees reimbursements	150,000
Reduction of Public Library funds	50,000
Total Revenue Loss for Fiscal Year 2003-04	$3,200,000

The Governor's budget proposal released on January 10, 2003 calls for the elimination of the State's backfill of the Motor Vehicle License Fees (VLF). VLF is a tax paid by vehicle owners each year based on the value of the vehicle. This tax was reduced by 67.5 percent in 1998 to vehicle owners with the State backfilling the revenue loss to local agencies. The 67.5 percent of the VLF is $2.9 million that is estimated to be lost to the City for next fiscal year.

Guiding Principles

Staff's approach to balancing the budget is based on the following overall guiding principles:

- Maintain essential services and facilities.
- Maximize organizational efficiencies.
- Minimize impacts on services to the public.
- Minimize impacts on employees.
- Protect long-term fiscal integrity.
- Provide a sustainable level and mix of City services.

Potential Budget-Balancing Strategies

The City's approach to the budget is based on the application of sound financial principles with the objective of long-term financial stability. In a retrenchment, it is important to maintain financial discipline by avoiding reductions that create long-term liabilities or inappropriately utilize reserves and one-time revenues to fund annual operating costs. The danger in implementing short-term budget solutions, such as using reserves for operating costs, based on the assumption that revenues will improve substantially in the near term, is that the recovery may not occur when or to the extent anticipated. Reserves that took many years to accumulate could be depleted, the City's financial position eroded and the deferred budget reduction more difficult to implement. At the end of the fiscal year, recurring operating revenues must be equal to or greater than recurring expenditures for salaries, benefits, services, supplies and debt service. Some flexibility exists in funding equipment replacement and capital outlay from nonoperating revenues without inappropriately deviating from sound financial principles. The potential budget-balancing strategies available to the City are:

- Streamline operations where possible to reduce cost.
- Restructure the use of certain revenues and funding of selected expenditures.
- Economic Development (long term).
- Extend equipment replacement schedules.
- Reduce or defer capital outlay.
- Review annual capital maintenance projects and extend existing funds through the coming fiscal year.
- Review employee compensation adjustments.
- Reduce staffing levels.
- Reduce service levels.
- Increase fees/taxes.
- Carefully use reserves and available balances to transition operations.

No specific budget-balancing recommendations are being made at this time. Staff will review the range of budget-balancing approaches and proposed guiding principles as it continues to develop a budget for the upcoming fiscal year.

Budget Process / Schedule

The budget process begins in November of each fiscal year when all City departments begin preparation of their budget proposals for the upcoming fiscal year.

Departments submit budget requests to the Budget Review Team (consisting of the Assistant City Manager and the Finance and Administrative Services Director) in late December. The Budget Review Team reviews these requests and submits recommendations to the City Manager.

The City Manager assesses the Budget Review Team's recommendations, meets with department heads for further discussion and submits recommendations to the City Council in the form of the Narrative Budget Report in early May. The City Council then reviews and discusses the Proposed Budget at budget hearings in early June. The City's annual budget must be adopted prior to the beginning of each fiscal year (July 1). This process follows and complies with City Charter Sections 1103 to 1105 regarding adoption of the annual City budget.

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Attachment